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CITATIONS

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In the Supreme Court of the United States

OCTOBER TERM, 1947

No. 146

ARTHUR D. SCHULTE, JOHN S. SCHULTE AND DAVID A. SCHULTE, JR., AS TRUSTEES UNDER A TRUST AGREEMENT DATED JUNE 3, 1932, MADE BY DAVID A. SCHULTE, AS GRANTOR, PETITIONERS

v.

PARK & TILFORD, INC.

UNITED STATES OF AMERICA, INTERVENOR

MARJORIE D. KOGAN, ON HER OWN BEHALF AND ON BEHALF OF ALL OTHER STOCKHOLDERS OF PARK & TILFORD, INC. SIMILARLY SITUATED, AND IN THE RIGHT OF PARK & TILFORD, INC., INTERVENOR

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES, INTERVENOR, AND THE SECURITIES AND EXCHANGE COMMISSION, AMICUS CURIAE, IN OPPOSITION

The United States intervened below because the constitutionality of Section 16 (b) of the Securities Exchange Act of 1934 (48 Stat. 896,

15 U. S. C. 78p (b)) as applied to the transactions here involved was drawn in question by the petitioners (R. 16–20). The Securities and Exchange Commission, which administers the Act, participated below as *amicus curiae* on the questions of construction of the Act raised in the proceedings. For the convenience of the Court, the views of both the United States and the Commission are here presented in a single brief.

OPINIONS BELOW

The memorandum opinion of the district court (R. 85–90) is not reported. The opinions of the circuit court of appeals (R. 116–121, 142–147) are reported at 160 F. 2d 984 and 989.

JURISDICTION

The judgment of the circuit court of appeals was entered on January 8, 1947 (R. 122), and rehearing was denied on March 26, 1947 (R. 148). The petition for a writ of certiorari was filed on June 21, 1947. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925 (28 U. S. C. 347) which is made applicable by Section 27 of the Securities Exchange Act of 1934 (15 U. S. C. 78aa).

QUESTIONS PRESENTED

1. Whether the acquisition of common stock upon conversion of preferred is a "purchase" of the common within the meaning of Section 16

(b) of the Securities Exchange Act of 1934 so that any profit realized by the sale within six months of such common stock is recoverable by the issuer under the section.

2. Whether common stock acquired upon conversion comes within the exception provided in Section 16 (b) for securities acquired in good faith in connection with an antecedent debt.

3. Whether Section 16 (b), as applied to the transactions involved here, is an improper exercise of Congressional power under the commerce clause of the Constitution and involves a denial of due process of law.

STATUTE INVOLVED

Section 16 (b) of the Securities Exchange Act of 1934 (48 Stat. 896, 15 U. S. C. 78p (b)) provides:

> For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner,[1] director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security)

[1] The term "such beneficial owner," as here used, refers back to the phrase in Section 16 (a): "Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered on a national securities exchange." The term "equity security" is defined in Section 3 (a) (11) of the Act as meaning, among other things, "any stock or similar security."

within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this this subsection.

STATEMENT

The action which resulted in the judgment sought to be reviewed was instituted by Park & Tilford, Inc. on November 17, 1944, pursuant

to Section 16 (b) of the Act, to recover profits realized by petitioners on the purchase and sale within six months of 8,255 shares of common stock of Park & Tilford. This stock was registered on the New York Stock Exchange, a national securities exchange (R. 5). Petitioners, trustees under a family trust, were subject to the provisions of Section 16 (b) as beneficial owners of more than 10% of the common stock of Park & Tilford (R. 8, 33–34, 53, 79, 86). In fact, petitioners controlled the corporation through ownership of a majority of its common voting stock and also owned a majority of the convertible preferred stock of the corporation (R. 76, 98, 145). The settlor of the trust, their father, was a former president of Park & Tilford, and in 1945 chairman of its board of directors. One of the petitioners was also a member of the corporation's board (R. 97–98).

On January 19, 1944, the petitioners exercised their privilege to convert 6,604 shares of the preferred stock, which they had acquired in 1937, into common stock in the ratio of 1¼ shares of common stock for each share of preferred, as provided in the certificate of incorporation. They thus acquired the 8,255 shares of the common stock in question on that date (R. 8–9, 34, 79).[2]

[2] About two months prior to the conversion, Park & Tilford's board of directors had decided to redeem, as of March 20, 1944, all the outstanding preferred stock ($50 par value) at $55 per share plus accrued dividends, if any, to the redemp-

It appears that beginning late in 1943 and ending in May, 1944, there was a spectacular rise in the market price of Park & Tilford common stock as a result of rumors of an impending liquor dividend by the company (see R. 23, 118). It was during this rising market that the petitioners elected to exercise their privilege to convert their preferred stock into common. On the conversion date, January 19, 1944, the stipulated market price of the common stock was $58.25 per share or $480,853.75 for 8,255 shares (R. 6–7, 81). Within six months thereafter, when much higher prices were reached, the petitioners sold 8,255 shares of common stock along with some 30,000 additional common shares held by them (R. 6, 37, 55, 80).

The highest prices at which 8,255 shares of such common stock were sold ranged between $93 and $98 per share between May 6 and May 26, 1944, for a total of $782,999.59 (R. 55).[3] The $302,145.81 profit claimed (R. 33, fol. 97) by Park & Tilford from the petitioners was the difference between this total and the stipulated market value of the 8,255 shares of common stock at the time of conversion (the purchase) (R. 55,

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tion date. Formal notice of the redemption call was given on December 20, 1943. The conversion privilege was exercisable at any time prior to the redemption date (R. 10–11, 34–35, 64).

[3] The record indicates that thereafter when the exact nature of the liquor distribution was made known to the public, the market price of the common fell precipitately (see R. 23, 145–146).

56, 61), pursuant to the rule for computing profits in Section 16 (b) cases—"lowest price in, highest price out"—enunciated in *Smolowe* v. *Delendo Corp.*, 136 F. 2d 231, 239 (C. C. A. 2), certiorari denied, 320 U. S. 751.

On January 31, 1946, the district court entered judgment in favor of Park & Tilford against petitioners in the sum of $302,145.81, with interest from May 26, 1944 (R. 83–84). The court held that petitioners' acquisition of common stock by conversion was a "purchase" of the common within the meaning of Section 16 (b) of the Act (R. 87). The court rejected petitioners' contention that the acquisition by conversion was within the exception provided in Section 16 (b) for good faith acquisitions in connection with an antecedent debt (R. 90). Finally, the court held that Section 16 (b) as applied to such acquisitions was constitutional (R. 90).[4]

On appeal, the circuit court of appeals accepted the conclusions of the district court on the questions of validity and construction of Section 16 (b) set forth above. However, it disagreed as to the measure of recovery, concluding that the amount of the judgment was too small. This re-examination of the question of damages was prompted by the contentions of Marjorie D.

[4] The same conclusions were reached in *Kogan* v. *Schulte*, 61 F. Supp. 604 (S. D. N. Y.) a separate action brought by Kogan, an intervenor herein (R. 87–88, 119).

Kogan, a minority stockholder of Park & Tilford, who had been permitted to intervene on the appeal because of the corporation's inadequate representation of minority stockholders (R. 121). The court recomputed the recoverable profit at $418,128.59 on the ground that the "purchase" price of the common was not the market value of the common acquired on conversion, but rather the lower market value of the preferred on the conversion date as stipulated by the parties and found by the district judge (R. 120). Accordingly, on January 8, 1947, the circuit court of appeals vacated the judgment and remanded the action to the district court for the award of a judgment for $418,128.59 with interest and costs (R. 122).

A petition for rehearing relating solely to the increase in the amount of the judgment was denied, one judge dissenting (R. 142–147). The petition for a writ of certiorari does not request review on the issue of damages.

ARGUMENT

Generally speaking the Securities Exchange Act of 1934 is designed to insure a fair and honest market which will reflect an evaluation of securities in the light of all available and pertinent data. Section 16 (b) implements this general purpose by making it unprofitable for insiders to engage in short-swing speculations on the basis of advance information available to them but not

known to "outside" stockholders and the investing public. The preamble to the section states that it was enacted: "For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer * * *"

Liability under the section is based upon the profit realized by insiders from "any purchase and sale, or any sale and purchase" within a six months period. The section carries no penal consequences for failure to comply with the standard of conduct defined in it (cf. Pet. 8). It merely attempts to guard against the use of inside information by such persons by requiring the restoration to the company of any profit realized through "in and out" trading within the statutory period.[5]

1. The coverage of the term "purchase" as used in Section 16 (b) of the Securities Exchange Act of 1934 must be determined in the light of the definition contained in Section 3 (a) (13) of the Act and the broad remedial purpose of the statute, rather than by reference to the meaning accorded to such term when used in other con-

[5] In order to effectuate the purpose of the section and to strike at the "tendency to evil", Congress established an objective measure of proof under the section, thus making it unnecessary to show an actual misuse of inside information in a particular case. *Smolowe* v. *Delendo Corp.*, 136 F. 2d 231, 239 (C. C. A. 2), certiorari denied, 320 U. S. 751.

texts (see Pet. 7–8). Section 3 (a) (13) of the Act defines the term "purchase" to "*include* any contract to * * * purchase, *or otherwise acquire*" [italics supplied]. Clearly, this definition comprehends not only an unexecuted contract to purchase or otherwise acquire a security, but also an executed contract of purchase or other acquisition, whether for cash or otherwise.

The term "purchase" in its ordinary signification refers to the executed transaction of purchase. No further definition would have been required in the statute had not the Congress intended to broaden the meaning of the term to include both executory and executed transactions. Obviously, it was not intended to designate as a purchase executory contracts to acquire and exclude the much more important executed transactions. Moreover petitioner's argument deprives the word "include" of any significance.

While the thesis urged by the petitioners admits that the definition embraces executed transactions of purchase in the conventional sense, they deny its applicability to other types of executed acquisitions of securities. We believe this construction is plainly erroneous and that, with one exception specified in the statute,[6] Section 16

[6] At p. 12, *infra*, we discuss the exception contained in Section 16 (b) for securities acquired in good faith in payment of an antecedent debt. It would have been unnecessary to provide a specific exclusion for such acquisitions if the term "purchase" were restricted to conventional cash transactions.

(b) was clearly meant to include any mode of acquiring a security for consideration which is not exempted by the Commission under the section "as not comprehended within its purpose."

Accordingly, since the acquisition here involved is plainly a "purchase" under the statute, it is immaterial whether, as petitioners argue (Pet. 10), the 1937 acquisition of convertible preferred stock should also be considered as a purchase of the common stock on the theory that it contained a contract to acquire such common stock. To regard this 1937 transaction as a contract to acquire common stock, and thus a "purchase", in no way proves that the 1944 transaction by which the petitioners actually acquired the common stock upon conversion was not also a "purchase" of the common stock within the meaning of the Act.

Reference to the intent of the Congress lends no support to the position urged by the petitioners, but rather the contrary; their construction would render the section largely ineffective to discourage short term insider trading. The exercise of a conversion privilege can be as much a vehicle for the misuse of inside information as any other transaction of purchase. Under the petitioners' construction insiders could with a minimum of risk acquire senior securities with conversion privileges, and at the opportune time capitalize on inside information by converting into more volatile

junior securities and then selling out for a quick profit just before the market drops. The facts involved in the present case (*supra,* pp. 5–6) illustrate plainly the possibilities for capitalizing on the insiders' strategic position in such situations and demonstrate that they cannot be taken outside the scope of the statute without doing violence to its purpose.

2. The court below correctly held that an acquisition of securities upon conversion is not within the exception provided in Section 16 (b) for securities "acquired in good faith in connection with a debt previously contracted." This exception is clearly inapplicable to any transactions other than those in connection with actual debts. As stated by the court below (R. 119), "It is a strained concept, indeed, to regard preferred stock convertible into common as a debt here."[7] We believe that the statutory exception was intended to deal with the situation where an ordinary pre-existing cash debt is satisfied in whole or in part by the transfer of securities because the creditor believes in good faith that it is not feasible to insist on payment in cash. It is evident that Congress considered that this kind of transaction was so far removed from

[7] See *In re Phoenix Hotel Co. of Lexington, Ky.*, 83 F. 2d 724, 727, 728 (C. C. A. 6, 1936), certiorari denied, *Security Trust Co.* v. *Baker*, 299 U. S. 568. See also Section 3 (a) (11) of the Securities Exchange Act of 1934, 15 U. S. C. 78c (a) (11).

the evil sought to be remedied as to be specifically exempted in the statute.[8]

Petitioners concede that as stockholders they were not creditors of Park & Tilford (Pet. 15). They contend, however, that they were creditors because they owned an additional contractual conversion right, and that breach of this right is compensable in damages (Pet. 13). This argument overlooks the fact that no debt would arise until there was a breach of the conversion right and damage resulted and, of course, the statutory reference is to pre-existing debts. See *Cheatham* v. *Wheeling & L. E. Ry. Co.*, 37 F. 2d 593 (S. D. N. Y. 1930). It is clear that whatever the relationship of the petitioners to Park & Tilford might have been had the company refused to convert, that situation does not obtain in this case.

The petitioners' broad construction of the term "debt" to include the obligation to deliver stock pursuant to a contractual right (Pet. 13–15) would result in the exclusion from the operation of the section of acquisitions upon the exercise of option warrants. Such a construction would open a door to manipulative practices expressly

[8] Other kinds of transactions which might be found to be appropriate for exemption were left to the exemptive rule-making authority of the Commission if it should conclude that such transactions are not comprehended within the purposes of Section 16 (b). Petitioners do not contend that acquisitions upon conversion are within any of the exemptive rules promulgated by the Commission.

condemned by the Congress. S. Rep. No. 1455, 73d Cong., 2d Sess., pp. 55–63. Indeed, the petitioners appear to admit the undesirability of excluding option warrants from the section (Pet. 10).

3. There is no merit in the argument of the petitioners that the statute, as applied to the situation at bar, is unconstitutional. In *Smolowe* v. *Delendo Corp.*, 136 F. 2d 231 (C. C. A. 2), certiorari denied, 320 U. S. 751, it was held that Section 16 (b), even as applied to private transactions, is a proper exercise of Congressional power under the commerce clause of the Constitution and that the statute so interpreted does not infringe due process guaranties. The principles there applied are equally dispositive of the issues now raised by the petitioners.[9]

(a) The remedy provided in Section 16 (b) is operative only with respect to securities registered on a national securities exchange. There

[9]As stated previously, petitioners do not raise any question as to the correctness of the interpretation of the record upon which the majority of the Court below computed the amount required to be added to the judgment of the District Court, in order to reflect the cost of the Park & Tilford common stock acquired by petitioners upon conversion of the preferred stock. That question appears to turn in part upon a question of practice as to the circumstances under which a stipulation in open court may be repudiated and in part upon a factual analysis peculiar to the instant case. Irrespective of the correctness of this ruling, upon which the court below divided, the constitutional issue presented appears to be no different from that involved in *Smolowe* v. *Delendo Corp.* cited in the text.

can be no doubt that transactions on such exchanges may be regulated under the commerce clause of the Constitution. *Electric Bond & Share Co.* v. *Securities and Exchange Commission,* 303 U. S. 419, 440. Private transactions in listed securities are likewise subject to Congressional regulation since they "affect stock quotations on national security exchanges—and thus interstate commerce." *Smolowe* v. *Delendo Corp.,* 136 F. 2d 231, 240 (C. C. A. 2), certiorari denied, 320 U. S. 751; *cf. North American Company* v. *Securities and Exchange Commission,* 327 U. S. 686. The acquisition of common stock upon exercise of a conversion privilege affects quotations in that stock no less than the private transactions involved in the *Smolowe* case.

Section 16 (b) read in the light of the findings in Section 2 of the Act (15 U. S. S. 78b),[10] is a declaration by the Congress that all short-swing trading by insiders in securities listed on national securities exchanges affects interstate commerce, regardless of whether the transactions are them-

[10] "Sec. 2. * * * transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, including transactions by officers, directors, and principal security holders, * * * to impose requirements necessary to make such regulation and control reasonably complete and effective, in order to protect interstate commerce * * * and to insure the maintenance of fair and honest markets in such transactions * * *."

selves carried on in interstate commerce. This determination is plainly reasonable and should not be disturbed by the courts. *United States* v. *Darby,* 312 U. S. 100, 120–121.

In any event, Section 16 (b) does not purport to attach civil liability to the purchase transaction alone, but only to such transaction when coupled with a sale within six months. Petitioners do not contend that their sales of the common stock acquired on conversion were intrastate transactions. Therefore, if their sales of common stock are within the commerce power, even assuming that the conversion alone is not, there can be no doubt that Section 16 (b), as applied to these transactions, is a legitimate exercise of the Congressional power.

(b) Section 16 (b), as construed by the court below, involves no want of due process of law. The section was adopted by the Congress only after an extensive investigation and upon a considered finding of the abuses of inside speculation. As a device to deter insiders from speculating in their knowledge of their corporation's affairs, the section is but a reasonable adaptation of common law principles which have long been accepted by the courts in comparable situations. *Cf. Woods* v. *City National Bank,* 312 U. S. 262; *Meinhard* v. *Salmon,* 249 N. Y. 458, 164 N. E. 545. As pointed out in *Smolowe* v. *Delendo Corp.,* 132 F. 2d 231, 239 (C. C. A. 2), certiorari denied, 320 U. S. 751, the section is a reasonable legis-

lative restriction upon the evil sought to be prevented.

The petitioners contend, however (Pet. 16), that if Section 16 (b) is applied to an acquisition of stock upon conversion, it would not bear a reasonable relationship to the object sought to be accomplished. There has been no showing, they argue, that the use of the conversion privilege can contribute to the evils sought to be remedied by the section. Apart from the broad nature of the Congressional findings underlying the enactment, we submit that the facts involved in this very case demonstrate plainly that the "tendency to evil" at which the statute strikes inheres in a conversion situation (see *supra,* pp. 5–6, 11–12).

Nor is there any question, as petitioners suggest, of impairment of vested conversion rights (Pet. 15). As we have indicated, the section does not prohibit acquisitions upon conversion; its impact is only upon the "short-swing" resulting, in this case, from the subsequent sale of the securities so acquired at a profit within the specified period. Moreover, the convertible securities were issued and acquired by the petitioners after the passage of the Act. In any event, there can be no question as to the power of Congress in the regulation of interstate commerce to condition the exercise of preexisting contract rights. *Continental Ill. Natl. Bank & Trust Co.* v. *Chicago, R. I., & P. R. Co.,* 294 U. S. 648, 680.

CONCLUSION

The decision below is correct, and there is no conflict of decisions. The petition for a writ of certiorari should be denied.

Respectfully submitted.

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